ROBECO
The Investment Engineers

Fixed Income Outlook Q4 2016

From negative policy rates to yield curve control: What's next?

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Summary: Our key themes

- *Low growth, low inflation*
  We see no reason to deviate from our base case scenario for the global economy, which centers around low growth and low inflation. Political risk in advanced economies is on the rise. Policy uncertainty will increase with the US elections in November and the constitutional Italian referendum in December. Next year, elections are scheduled in many European countries. Early 2017, Brexit negotiations will officially start, which could give rise to more uncertainty. The recovery in commodity markets is supportive for emerging economies and in many countries falling inflation is allowing central banks to ease monetary policy. Imminent worries on the Chinese economic outlook have come down, but long-term challenges and risks remain.

- *Emerging (local) debt has further to go*
  A global economy that is neither overheating nor on the brink of a recession, is a favorable macro environment for the asset category. In a low growth, low inflation world the Fed will not normalize official target rates aggressively. Part of the global liquidity flood other central banks (Bank of Japan, Bank of England and European Central Bank) are providing is finding its way to emerging markets. Investor flows confirm this improving technical backdrop. From a valuation perspective local debt looks appealing. Many central banks have tightened policy in recent years to defend their currencies. This has driven up real yields levels across the universe. As core yields moved lower, the yield differential with

developed markets increased in recent years. This year, most currencies have appreciated versus both the US dollar and the euro, but they are by no means back at pre-taper 2013 levels. The fundamental outlook for most countries remains the weak spot, but even here in some cases cautious optimism looks warranted.

- *No value in front end US yield curve*
  Money market future contracts show that rate hike expectations for the US Fed have come down a lot. Between one and two rate hikes are now being discounted for the coming two years. The Fed recently confirmed this very gradual normalization trajectory when it updated its 'dot plot', which shows the projections of the 16 members of the FOMC. From a valuation perspective we limit the duration exposure in the US to 7 years.

- *Be selective within credits: focus remains on Europe and subordinated financials*
  Average valuation, positive technicals and deteriorating fundamentals. That is in a nutshell our take on the broader credit market. Differences between the subsectors are significant, so there is something to choose. We continue to prefer subordinated financials. For this category we would argue that valuation is attractive as spreads are nearly three times as high as on senior financial bonds. From the perspective of a bond holder fundamentals are improving. Banks are clearly in a deleveraging mode as opposed to many (US) corporate issuers, where leverage is back at 2008 peak levels. Idiosyncratic risk needs to be managed though. Issue selection remains key. We prefer issuers from the United Kingdom, the Netherlands and Switzerland to institutions from Germany, Italy and Austria.

Main views

Main asset categories	Total	Valuation	Technicals	Fundamentals
German Bunds	0	- -	+	0
US Treasuries	0	-	0	0
JGBs	-	- -	++	-
IG credits	0	0	0	-
High yield	-	0	0	-
EMD local debt	+	+	0	-
Euro peripheral debt	-	-	0	-

In focus

Yield curve control: the Bank of Japan's latest experiment

The Bank of Japan (BoJ) did it again: just when market participants had become familiar with quantitative easing and negative interest rates, it surprised with its latest monetary experiment: 'yield curve control'. A powerful answer to those claiming that the toolbox of central banks looks empty or a clear sign of 'policy exhaustion'?

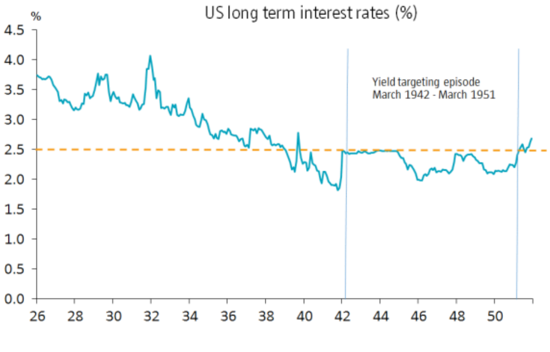
The move is not totally unprecedented. A comparable approach was adopted by the Fed after World War II. The aim of the US government and the Fed was to avoid another depression and to accommodate employment creation (Employment Act of 1946). Official interest rates were kept close to zero and the Fed continued the war-time policy of purchasing Treasury bonds, keeping long-term interest rates below 2.5%. Between 1953 and 1960, the Fed gradually ceased intervening in the pricing of longer term Treasury bonds as inflation moved higher.

Under the new regime the BoJ will not only target short-term policy interest rates, but also 10-year yield levels. In doing so it can enforce a steeper yield curve, which is supportive for the banking sector. It can also be regarded as an open invitation to the Abe government to boost fiscal spending. If the additional issuance of government bonds were to push up yields, the central bank now has the flexibility to intervene in the market.

Does it pave the way for full-blown helicopter money? In the absence of a significant financial market or economic crisis, we don't think so. However, the new framework does bring the BoJ a lot in terms of flexibility, sustainability and, perhaps at at some stage, credibility of its policy. In our view it is quite possible that the monetary authority will opt for more rate cuts now that it has the tools to keep the shape of the curve stable. We might not have seen the lows in the country's yield levels after all.

Japan can be regarded as the world's laboratory for unconventional monetary policy. Already for this reason it is important to monitor developments closely. Almost every advanced economy is faced with the same economic challenges such as low productivity growth, rapid population ageing and elevated public debt ratios. Only in the case of Japan the urgency to face these challenges appears to be higher. A global policy shift away from monetary expansion and a comeback of fiscal expansionary policies could very well start in Japan.

Figure 1 | Bond yield targeting in the US



Source: Federal Reserve, Robeco

Treasuries

Valuation: benchmark duration on the rise, index-focused bond investors beware

Just as global yields set record lows, durations of fixed income indices are moving up rapidly. This is mainly caused by governments aiming to lock in low borrowing costs by issuing longer dated bonds. This effect recently gathered pace. Over the last 30 years the duration of a widely used global government bonds index has almost doubled from 4.3 years to 8.1 years at the end of September 2016. In the last two years, the duration has increased by one year. For those fixed income investors that tend to follow or even mimic indices, a potentially toxic combination is in the making. Just as interest rate risk in index-related fixed income products is moving higher, compensation for that risk is falling rapidly. Stay tuned.

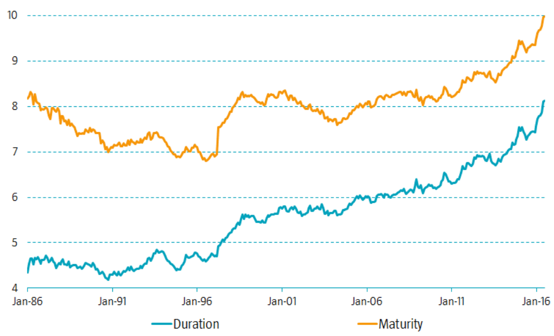
Technicals: keep calm and carry on.... if only carry existed

The outcomes of the most recent BoJ and FOMC policy meetings have depressed rates volatility further. Measures of implied volatility for the US Treasury market moved to the lowest point in almost two years[1]. The updated 'dot plot' suggest the median FOMC member expect one rate hike for 2016 and at most two more for 2017. Market expectations are even more relaxed. Not even one rate hike before 2017 is fully being discounted by the money market strip. The BoJ's comprehensive reassessment resulted in several changes to its policy approach, among them making yield curve control a centerpiece of its new framework. Time will tell whether the drop in volatility will be sustainable. For now carry strategies could benefit from this environment if only developed core rates markets would offer any carry.

Fundamentals: has the US cycle peaked?

We see a real risk that the US economic cycle is slowly dying down. Capital expenditures have failed to move up. M&A actvity is declining. Labor market indicators are stabilizing. The US consumer is the only source of growth, but a deceleraration of household income is clouding the outlook for further growth. In Europe too, consumer demand has already stopped accelerating. EMU unemployment has failed to move lower now for four months in a row. Meanwhile wage inflation in all advanced economies remains muted. Inflation will rise in the coming months due to base effects in the oil price. Apart from that there is not much happening in the inflation outlook. Inflation expectations as measured by the the market continue to hover around low levels. This remains uncomforting for monetary authorities.

Figure 2 | Duration and maturity of global government bond market



Source: Robeco, J.P. Morgan Government Bond Index Global

[1] Merrill Lynch Option Volatility Estimate MOVE Index

Credits

Valuation: neutral at best

Is there any value left in credits? Yields and spreads are low, but US corporate spreads are just below below the long-term average and compared with negatively yielding government bonds the average 70 bp yield for European investment grade corporate credits seems attractive. Within credits there are specific pockets of value. Subordinated financials have some catching up to do as they have trailed senior non-financial bond returns so far this year. Admittedly for a reason (Italian banking woes, coupon fears, Deutsche Bank etc), but at spreads of nearly three times senior bond spreads this segment looks attractive. We are in an advanced stage of the credit cycle and research is warranted. Two-thirds of the euro corporate credit market trades at spread of less than 100 bp over Bunds, which leaves little room for error, especially as the duration is steadily increasing. Valuation is neutral at best.

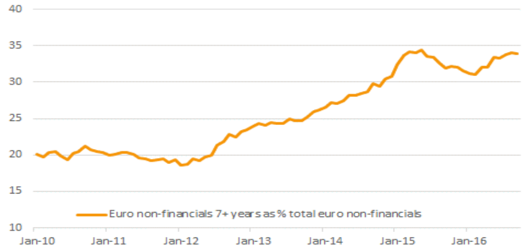
Technicals: CSPP a near-term support

The European Central Bank (ECB)'s corporate sector purchase program (CSPP) provides a near-term support for the euro corporate bond market, for the secondary but also for the primary market. The ECB is buying corporate debt at a pace of around two billion euros per week. By year-end it will have bought over 50 billion and by the end of the first quarter next year around 10% of the eligible universe. Corporates see the benefits, issuing not only more, but also longer dated debt. More than half of the issuance in the euro is longer than 7 years, 25% even longer than 10 years. The risk of oversupplying the market with debt is increasing, especially if and when the ECB stops buying and reinvesting in the future. The market becomes addicted to the ECB. Issuance in the US is also strong and so far met with solid demand, driven by investors chasing return, but market liquidity is thin and easily disturbed.

Fundamentals: It is not getting any better

The strong issuance of corporate debt, both investment grade and high yield, combined with faltering profits shows up in an increase in leverage. Current leverage for US investment grade corporates is already as high as the 2008 peak level, with an increase across sectors and ratings. More than one third of US IG corporates has a leverage of more than 4 times EBITDA; in 2010 this percentage only stood at one tenth. Corporates are using cash for share buybacks and dividends. Low yields are still keeping the coverage ratios comfortably high, but this ratio has been declining since 2014. Still, as long as the economy continues to grow, with a very gradual pace of Fed rate hikes, the deteriorating fundamentals should remain manageable. The default rate is expected to be moderating after a strong rise early in the year. Corporate actions and a rise in commodity prices should keep a lid on defaults.

Figure 3 | Long dated bonds as a percentage of the euro non-financial corporate universe



Source: Barclays Point, Robeco

Emerging (local) debt

Valuation: still attractive after a good run year-to-date

In the aftermath of the taper tantrum in early 2013, many central banks across the emerging universe hiked official target rates to defend their currencies and combat inflationary pressures and capital outflows. As a result real (short dated) yields look attractive, especially when compared with the start of 2013, just before Bernanke's words triggered turmoil in emerging markets. Across the curve the average yield on emerging local debt now equals 6.2%, which also compares favorably with developed markets bond yields. Emerging currencies appreciated a lot in the first quarter of this year and have stabilized since. Also here compared with pre-taper levels valuation looks attractive. We are roughly back at the levels of the final quarter of last year, but still 30% to 40% below pre-taper levels.

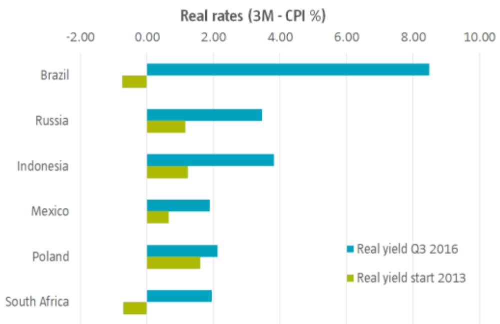
Technicals: inflows continue, reduced risk of aggressive Fed policy

The outperformance of emerging (local) debt over most other fixed income asset classes year-to-date has encouraged inflows from investors chasing returns. But most of these inflows have taken place in hard currency bonds instead of local bonds. So although sentiment towards emerging markets has improved, and investing in emerging countries has become less non-consensus, emerging local debt remains under-owned. US elections might pose a risk to the asset class, as a bad outcome will likely hurt overall sentiment in financial markets, and especially hurt markets like Mexico. This is already visible in the volatility of the Mexican peso, which reacts strongly to US poll results.

Fundamentals: some improvements, many challenges

Emerging markets continue to diverge from a fundamental perspective, and making statements about the asset class as a whole is potentially misleading. Recent Chinese economic data seem to have improved somewhat, but risks are building up as long as the government continues to kick the debt can down the road and does not properly address the imbalances in the economy. Indonesia is a good example of a country in which fundamentals are improving, and reforms are being implemented. The first phase of the recently introduced tax amnesty law is seen as a succes as the government has collected USD 7.5 billion in additional tax revenues so far. On the other side of the spectrum the political situation in both Turkey and South Africa is deteriorating, which has already resulted in a Turkish rating downgrade recently, and is likely to result in a rating downgrade in South Africa in December.

Figure 4 | Real rates for selected emerging countries



Source: Bloomberg, Robeco

Portfolio positioning

Highlights Robeco Global Total Return Bond Fund*

- *Duration*: The portfolio's duration is 6.1 years. The bulk of the interest rate exposure is concentrated in USD and EUR securities. During September exposure in 10-year Japanese government bonds was added and holdings in UK Gilts were reduced.
- *Yield curve*: The interest rate expsure in the US is concentrated in maturities of 7 years and longer. The portfolio holds shorter dated US credits, but the duration is hedged out.
- *Credits*: The fund has a preference for European subordinated financial bonds. The exposure equals 8% of the portfolio. Most of these holdings are lower Tier 2 and investment grade. The overall exposure to the most deeply subordinated financial bonds, AT1s and/or Cocos, is close to 1%.
- *EMD*: The overall allocation to emerging local debt equals 7% of the portfolio. Brazil and Indonesia are our favorite markets.
- *FX*: The exposure to emerging currencies (7%) is held against short positions in both the euro and the US dollar. More than 94% of the fund is denominated in the fund's base currency.

Highlights Robeco All Strategy Euro Bonds*

- *Duration*: The portfolio's duration is 6.9 years, in line with the 6.9 years for the Barclays Euro Aggregate index.
- *Yield curve*: There is no preference for a particular part of the yield curve.
- *Credits*: The exposure to cash credits is 26.8% with an additional 5.5% in European asset-backed securities (ABS). The fund has a preference for European subordinated financial bonds. The overall exposure to this credit market segment amounts to 4.4%. The majority of these holdings is lower Tier 2 bank (2%) and dated subordinated insurance instruments (1.5%) and investment grade. The overall exposure to the most deeply subordinated financial bonds, AT1s and/or Cocos, is below 0.5%.
- *Euro peripheral government debt*: The overall exposure to peripheral government debt equals 10.6% of the portfolio, divided over Italian and Spanish government bonds. The positions in the periphery are skewed to maturities above 5 years.
- *FX*: There is a 2% position in the Swedish krona against the euro.

*Positions as of September 30, 2016

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